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## Can the Tax Efficiencies of ETF Redemptions In-Kind Be Replicated for Mutual Funds?

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The explosion in exchange-traded funds (ETFs) over the last 10 to 15 years has drawn attention to certain advantages of the ETF structure compared to that of mutual funds. By one estimate, ETFs have grown from approximately \$580 billion in total net assets 10 years ago to approximately \$3.32 trillion in total net assets today.<sup>1</sup> With the advent of Rule 6c-11 (ETF rule) and the continued development and growth of the ETF industry, it may be time for mutual fund managers to focus on opportunities for incorporating certain advantages of the ETF structure into mutual fund arrangements.

One of the advantages touted by sponsors of ETFs is their tax efficiency for investors. One aspect of this tax efficiency is derived from the ETF redemption process. Through this process, an ETF is able to distribute portfolio securities with a low cost basis (via redemptions in-kind) to authorized participants (APs), which means that tax distributions by the ETF to its retail investors are minimized.<sup>2</sup> The tax efficiency captured through this in-kind redemption process is available to mutual funds. However, impediments on mutual funds arising from how their shares are held and currently processed effectively limit the ability of mutual funds to effect redemptions in-kind in a meaningful way. By one estimate, long-term mutual funds in the aggregate paid an average of \$367 billion in capital gains in

the three most recently completed calendar years.<sup>3</sup> While ETFs also distribute capital gains, when comparing passive ETFs as a group with similar passive mutual funds, or active ETFs as a group with similar active mutual funds, the ETFs tend to pay out smaller capital gains distributions as a percentage of net asset value (NAV).<sup>4</sup> Based on the desire of many taxable fund shareholders to minimize taxable distributions from those funds, any effort by the mutual fund industry to that end likely would be well received by such shareholders.

This article explores how retail investors hold shares of ETFs and mutual funds and the process for purchasing and selling fund shares, including the legal background relating to redemptions in-kind for ETFs and mutual funds and the redemption in-kind impediments applicable to mutual funds arising from the arrangements through which mutual fund shares are held. This article also poses for consideration opportunities for addressing those impediments, which if pursued could result in mutual funds achieving the redemption in-kind tax efficiency enjoyed today by their ETF cousins.

### Background

Most ETFs are registered open-end management investment companies, a status that is shared with mutual funds. Open-end funds that are ETFs and mutual funds issue redeemable securities. The

Investment Company Act of 1940, as amended (1940 Act), defines a redeemable security as any security under the terms of which the holder, upon its presentation to the issuer, is entitled to receive approximately his or her proportionate share of the issuer's current net assets, or the cash equivalent thereof. Under this definition, the shareholder of an ETF or mutual fund is entitled to his or her proportionate share of the fund's current net assets. The Securities and Exchange Commission (SEC or Commission) has stated that this definition traditionally has been interpreted as giving the issuer the option of redeeming its securities in cash or in-kind.<sup>5</sup>

### **ETF Shareholding and Related Processing Arrangements**

ETFs issue shares to and redeem shares from APs, each of which is required to be a participant of a clearing agency registered with the Commission.<sup>6</sup> A clearing agency is required to register with the SEC under Section 17A of the 1934 Act and the clearing agency's rules are required to restrict its participants to registered broker-dealers, other registered clearing agencies, funds, banks, insurance companies, or other persons specified by rule.<sup>7</sup> Accordingly, APs are limited to financial institutions or other types of institutional investors. Retail investors may purchase and sell ETF shares on an exchange, but may not directly purchase shares from or redeem shares with the ETF.

To acquire ETF shares, the AP purchases portfolio securities approved by the ETF in a creation basket (basket) and exchanges the basket with the ETF for large blocks of ETF shares, known as creation units (creation units).<sup>8</sup> To redeem ETF shares, the AP exchanges one or more creation units with the ETF for baskets (of portfolio securities). For US federal income tax purposes, when the ETF delivers the basket (of portfolio securities) to the AP in exchange for creation units, such delivery of portfolio securities is not treated as a sale of the portfolio securities by the ETF resulting in the realization of capital gains for the ETF.<sup>9</sup> This in-kind redemption benefits

the ETF and its investors as the ETF may distribute low cost basis portfolio securities in the redemption, which if sold by the ETF to fund a cash distribution would result in taxable gains that would ultimately be distributed to the ETF's investors under applicable requirements of Subchapter M of the Internal Revenue Code.<sup>10</sup>

Because ETFs use relatively few APs,<sup>11</sup> APs are likely to be a beneficial or record owner of five percent or more of an ETF's shares, making any such AP an affiliated person of the fund.<sup>12</sup> Section 17(a) of the 1940 Act prohibits principal transactions between a fund and any of its affiliated persons (or affiliates of affiliates).<sup>13</sup> For this reason, ETFs require the exemptive relief provided by Rule 6c-11 to create and redeem in-kind with any AP that may be an affiliated person of the fund (or an affiliate of an affiliate).<sup>14</sup>

### **Mutual Fund Shareholding and Related Processing Arrangements**

Mutual fund shares typically are available directly from the fund (through transactions with the fund's transfer agent) and indirectly through intermediaries that have selling and/or servicing arrangements with the fund or its distributor. Because intermediaries offer their customers a variety of services that are not available from the fund, or which are part of a package of services that the intermediary provides to the customer with respect to fund and non-fund investments, the indirect holding of mutual fund shares through intermediaries has overtaken and surpassed the direct holding method in the last 30 years.<sup>15</sup> In 2018, only 19 percent of mutual fund-owning households purchased the fund directly.<sup>16</sup> The remainder of mutual fund-owning households either held shares through an employer-sponsored retirement plan or through an investment professional.<sup>17</sup>

The movement to indirect ownership of mutual fund shares was facilitated by the provision in 1986 by National Securities Clearing Corporation (NSCC), a clearing corporation registered with the Commission, of an automated service for

processing mutual fund share transactions, Fund/SERV.<sup>18</sup> Access to Fund/SERV is limited to Fund/SERV participants, which generally consist of broker-dealers, funds and fund transfer agents.<sup>19</sup> Fund/SERV electronically transmits orders for purchases and redemptions from intermediaries to the fund through NSCC.<sup>20</sup> Orders from intermediaries for a particular fund are collected by NSCC, which on a set schedule transmits the orders to the fund's transfer agent for processing.<sup>21</sup> The transfer agent for the fund processes the orders and provides confirmations that are transmitted through NSCC to the intermediaries.<sup>22</sup> Funds and intermediaries, as part of their membership in NSCC, permit NSCC to either credit or debit a designated bank account daily to settle payments due as a result of the processed orders.<sup>23</sup>

Intermediaries utilizing NSCC and Fund/SERV to process fund share transactions reflect critical elements of the process in their contractual arrangements with mutual funds. Many limit processing of fund share transactions to this process, including limiting payments to or from the fund to cash (or the equivalent).

### **Impediments to Mutual Fund Redemptions In-Kind**

The 1940 Act permits a mutual fund to satisfy a redemption request in-kind, provided that the fund satisfies the redemption request within seven days of its receipt of the redemption request and the value of the redemption proceeds equals the aggregate value of the fund's shares redeemed as of the redemption date. There are, however, several historical impediments to mutual funds regularly satisfying redemption requests in-kind. The primary impediment arises from the contractual arrangements between funds and intermediaries, which incorporate the NSCC and Fund/SERV processing requirements discussed above, including the payments obligations of funds that are limited to cash (or the equivalent under the arrangement). In addition, intermediaries cite other reasons for requiring cash redemptions,

including risks to their customers arising from delays in receiving portfolio securities.

Another impediment was identified by former SEC Commissioner Piwowar in a speech at the Investment Company Institute conference in March 2015.<sup>24</sup> In the speech, he highlighted the restrictions imposed on funds by Rule 18f-1 under the 1940 Act. Rule 18f-1 was adopted in 1971 in response to certain states requiring funds to undertake to redeem resident shareholders in cash absent approval from the applicable state regulator.<sup>25</sup> Such an undertaking for only some shareholders raises concerns under Section 18(f)(1) of the 1940 Act, which prohibits funds from issuing senior securities (other than bank borrowings) and Section 18(g) of the 1940 Act, which defines a senior security, in part, as "any stock of a class having priority over any other class as to distribution of assets."<sup>26</sup> Rule 18f-1 provided an exemption from this prohibition, and any fund making an 18f-1 election commits itself to paying in cash redemption requests by any shareholder of record, limited in amount with respect to each shareholder during any 90-day period of the lesser of (1) \$250,000 or (2) one percent of the net asset value of the fund at the beginning of the period. Commissioner Piwowar went on to point out that any agreement by a fund to make payments to some shareholders in a manner different from payments to other shareholders, for example, in cash only, rather than in cash or in-kind, would be deemed to create a class of senior securities prohibited by Section 18(f)(1) of the 1940 Act.<sup>27</sup>

Fund disclosures that effectively limit the use of redemptions in-kind or that otherwise fail to highlight adequately risks relating to receiving portfolio securities also serve as an impediment to satisfying redemption requests in-kind. In connection with its adoption of Rule 22e-4, the Commission required funds that engage or reserve the right to engage in redemptions in-kind to adopt and implement written policies and procedures relating to such redemptions as part of a fund's liquidity risk management program.<sup>28</sup> At that time, the Commission also

amended Form N-1A, the registration form used by mutual funds, to require that a fund disclose the methods used to meet redemption requests (such as selling securities or redeeming in-kind).<sup>29</sup>

A fund's custodial arrangements also can serve as an impediment to effecting redemptions in-kind, either by failing to contemplate delivery of portfolio securities or by failing to address operational matters relating to delivering portfolio securities. Article 8 of the Uniform Commercial Code governs the process for transferring portfolio securities to a redeeming shareholder, and the mechanisms for transferring portfolio securities vary depending on whether the direct or indirect holding system is involved and whether the security is certificated or uncertificated.

Like ETFs, mutual funds are subject to the prohibitions of Section 17(a), which can serve as an impediment to satisfying in-kind a redemption request by an affiliate of the fund. A fund can redeem in-kind with affiliated shareholders in compliance with the conditions in the Signature Financial Group no-action letter, the conditions for which generally require board approval of the redemption or procedures that are intended to prevent the redemption from benefiting the affiliate at the expense of the fund, such as requiring the pro rata distribution of portfolio securities.<sup>30</sup>

## Potential Opportunities to Address the Impediments

The impediments identified above are not insurmountable.

### NSCC and Intermediary Arrangements

While NSCC and Fund/SERV were established specifically to address the difficulties of processing millions of fund share transactions daily and have largely done so, it may be time to augment the system to accommodate portfolio security transfers.<sup>31</sup> The ETF structure serves as an example. Many of the larger intermediaries that offer mutual fund shares also serve as APs, albeit not always through the same entity, and have the capability

to accept portfolio securities within their organizations. Often these same intermediaries are seeking portfolio securities for other parts of their or their affiliates' businesses (for example, to make available to their customers to cover short sales) and could benefit from developing a process for mutual funds to follow to effect redemptions in-kind for their customers. Perhaps one of these intermediaries or a third party could offer a service to mutual funds, which is mutually beneficial to funds and intermediaries (and their customers), to facilitate the delivery of portfolio securities or their conversion to cash.

Admittedly, the alternatives associated with satisfying redemptions in-kind transfer transaction costs resulting from the subsequent sale of portfolio securities from the fund to the shareholders receiving the in-kind securities. This cost transfer, however, benefits remaining shareholders of a fund and is consistent with the definition of redeemable security and policies of the Commission underlying certain of its recent rule proposals, such as the swing pricing proposal. Alternatively, this cost could be shared with remaining shareholders through the service referenced above. The potential tax efficiency that would accrue to remaining shareholders may justify the cost of such a service, if used, or the shared transaction costs of selling securities that are received in redemptions in-kind. If mutual funds can redeem in-kind on a scale that is comparable to ETFs, they could provide tax efficiencies on a more competitive basis than is presently the case with respect to those currently provided by comparable ETFs in the marketplace. Even if the increased use of mutual fund redemptions in-kind results in increased transaction costs for shareholders, we note that retail ETF shareholders also bear transaction costs to invest in ETFs, particularly when an ETF trades at a large premium or discount or with large bid/ask spreads.

Furthermore, and in light of the Commission's views underlying Section 18(f) and Rule 18f-1 and captured in former Commissioner Piwowar's 2015

speech, a question arises as to the rights of direct and indirect shareholders under the current system and its related contractual arrangements. Intermediary agreements could be amended to eliminate the cash only obligation and acknowledge the right of any mutual fund to satisfy redemptions in-kind, including outside of the Fund/SERV system, consistently with the requirements of the 1940 Act.

### Rule 18f-1

The National Securities Markets Improvement Act (NSMIA) amended Section 18 of the Securities Act of 1933, as amended, to effectively eliminate the state-imposed requirement that funds agree to effect redemptions in cash.<sup>32</sup> In his March 2015 speech, Commissioner Piwowar suggested that it was time to revisit Rule 18f-1. New funds need not make the Rule 18f-1 election as it is a permissive rule. Existing funds can request withdrawal of the election from the SEC.<sup>33</sup> While no fund appears to have applied for such a withdrawal, given that the concerns that motivated the adoption of Rule 18f-1 are now moot, the standard for revocation of such an election should ordinarily be met if the fund anticipates using the flexibility to redeem in-kind in a manner that is consistent with Section 18(f)(1). A fund could instead require that any redemption request over a certain threshold will be satisfied by a redemption in-kind and may limit intermediary relationships to financial intermediaries that would accept redemptions both in cash and in-kind.

### Disclosures

Prospectuses for many funds disclose that they typically pay redemptions in cash, and reserve the right to redeem in-kind.<sup>34</sup> In addition, for those funds that have made a Rule 18f-1 election, the fund discloses its obligation to pay in cash in accordance with the rule. These disclosures could be updated to describe how the fund would effect a redemption in-kind, the timing of the process and the risks relating to the process. A fund that has not made a Rule 18f-1 election, or that has been granted permission

to withdraw its election, could revise its disclosures to contemplate redemptions in-kind with respect to any shareholder, assuming any such disclosure is consistent with the fund's existing agreements with intermediaries.

### Custodial Arrangements

Like intermediary agreements, custodial agreements could be amended to address redemption in-kind processes. While certain of the processes for effecting delivery of portfolio securities under Article 8 are cumbersome, none should prevent delivery of portfolio securities or preclude a shareholder with a right to receive portfolio securities from selling those securities upon establishment of the right.<sup>35</sup>

### Conclusion

The potential opportunities for resolving the impediments to mutual funds redeeming in-kind to a similar extent as their ETF counterparts likely will require coordination among fund complexes, custodians, intermediaries and other service providers. Often the connotation associated with satisfying redemption requests in-kind is negative, but as noted above for mutual funds and their remaining shareholders, redemptions in-kind clearly offer economic benefits and warrant further consideration.

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### NOTES

- <sup>1</sup> See *Final Rule: Exchange Traded Funds*, SEC Rel. No. IC-33646 (Sept. 25, 2019) (Rule 6c-11 Adopting Release) at n.3 and *Proposed Rule: Exchange-Traded Funds*, SEC Rel. No. IC-28193 (Mar. 18, 2008) at n.5 and accompanying text.



<sup>2</sup> See “The ETF Tax Dodge Is Wall Street’s ‘Dirty Little Secret,’” *Bloomberg Businessweek* (Mar. 29, 2019) (discussing the favorable tax treatment of redeeming appreciated securities in-kind as an intended feature of the first versions of ETFs that were developed in the early 1990s and noting that the largest US ETF, SPY, has not reported a taxable gain in 22 years).

<sup>3</sup> Investment Company Institute, *2019 Investment Company Factbook* (2019 Factbook), at p. 221.

<sup>4</sup> Morningstar, “Measuring ETFs’ Tax Efficiency Versus Mutual Funds” (Aug. 7, 2019), available at <https://www.morningstar.com/articles/940313/measuring-etfs-tax-efficiency-versus-mutual-funds>. Most mutual funds and ETFs elect to be treated as “regulated investment companies” (RICs) under Internal Revenue Code of 1986, as amended (IRC) to avoid taxation at the fund level. RICs are required to generally pay as dividends all of their net capital gains every year to avoid being subject to taxes on those gains. See IRC § 852(b)(3). One asset manager that offers funds with an ETF and mutual fund share class was apparently able to drastically reduce or eliminate capital gains following the addition of an ETF share class (which was permitted under a unique exemptive order and involves mechanisms that are patented) to certain of its equity funds. Bloomberg, “Vanguard Patented a Way to Avoid Taxes on Mutual Funds” (May 1, 2019).

<sup>5</sup> See *Final Rule: Adoption of (1) Rule 18f-1 Under the Investment Company Act of 1940 to Permit Registered Open-End Investment Companies Which Have the Right to Redeem In Kind to Elect to Make Only Cash Redemptions and (2) Form N-18F-1*, SEC Rel. No. IC-6561 (June 14, 1971) (stating that the definition of “redeemable security” in the 1940 Act “has traditionally been interpreted as giving the issuer the option of redeeming its securities in cash or in kind.”).

<sup>6</sup> See Rule 6c-11(a)(1) (definition of “authorized participant”). A “clearing agency” is defined in the Securities Exchange Act of 1934, as amended (1934 Act), in relevant part as any person that, with respect

to transactions in securities, acts as intermediary for payments or deliveries or a securities depository that facilitates settlement of securities transactions without physical delivery of securities certificates. Section 3(a)(23)(A) of the 1934 Act.

<sup>7</sup> Section 17A(b)(3)(B) of the 1934 Act. The SEC has not added additional categories of persons to this list in the rules under Section 17A of the 1934 Act.

<sup>8</sup> See Rule 6c-11(a)(1) (specifically, the definitions of “authorized participant,” “basket,” and “creation unit”). Prior applications filed with the SEC for exemptive relief that was necessary prior to the effectiveness of that rule described the process in more detail. See *In the Matter of Alaia Capital, LLC and m+ ETF Trust*, SEC Rel. No. IC-33580 (notice) (July 30, 2019) (Alaia Capital Application) (describing the creation and redemption process as follows: “Shares will be purchased and redeemed in Creation Units only and generally on an in-kind basis. Except where the purchase or redemption will include cash under the limited circumstances specified in the application, purchasers will be required to purchase Creation Units by depositing specified instruments (Deposit Instruments), and shareholders redeeming their shares will receive specified instruments (Redemption Instruments). The Deposit Instruments and the Redemption Instruments will each correspond pro rata to the positions in the Fund’s portfolio (including cash positions) except as specified in the application”). The relief requested in the Alaia Capital Application was granted in SEC Rel. No. IC-33621 (Sept. 10, 2019).

<sup>9</sup> See IRC § 301(d).

<sup>10</sup> See IRC § 852(a)(1). Note, however, that any appreciation in price of the investor’s ETF shares since purchase are taxable gains for US federal income tax purposes once the shares are sold by the investor.

<sup>11</sup> According to an industry survey, in 2015, ETFs had an average of 34 APs. Investment Company Institute, *The Role and Activities of Authorized Participants of Exchange-Traded Funds* (March 2015) at p. 2. ETFs may have more liquidity providers than APs. See

- 2019 Factbook, *supra* n.3, at p. 87 (table showing that there is a median of 17 liquidity providers for ETFs and a median of four APs that are registered market makers for an ETF).
- <sup>12</sup> Under Section 2(a)(3) of the 1940 Act, a person “owning, controlling, or holding with the power to vote” 5 percent or more of an ETF’s shares is an “affiliated person” of the ETF.
- <sup>13</sup> ETFs do not require relief for in-cash purchases or redemptions as they can rely on the statutory exceptions in Sections 17(a)(1) and (a)(2) for purchases and sales of creation units for cash, because the only securities involved are shares of the ETF.
- <sup>14</sup> Rule 6c-11(b)(3). Because the in-kind redemption securities will be valued in the same manner as the ETF’s NAV, policy concerns underlying Sections 17(a)(1) and 17(a)(2) are addressed. *See* Rule 6c-11 Adopting Release at p. 44.
- <sup>15</sup> Investment Company Institute, *Navigating Intermediary Relationships* (Sept. 2009) at 2-3 (Intermediary Relationships Whitepaper).
- <sup>16</sup> 2019 Factbook, *supra* n.3, at p. 144.
- <sup>17</sup> *Id.*
- <sup>18</sup> *See* Intermediary Relationships Whitepaper, *supra* n.15, at p. 24.
- <sup>19</sup> *See* DTCC Fund/SERV Overview, <http://www.dtcc.com/wealth-management-services/mutual-fund-services/fund-serv> (noting service is limited to NSCC members) and National Securities Clearing Corporation Rules and Procedures (Dec. 11, 2019), Rule 2A and Addendum B.
- <sup>20</sup> *See* Intermediary Relationships Whitepaper, *supra* n.15, at p. 18.
- <sup>21</sup> *Id.*
- <sup>22</sup> *Id.*
- <sup>23</sup> *See id.*, *supra* n.15, at 5 and 18.
- <sup>24</sup> Commissioner Michael S. Piowar, Remarks at the 2015 Mutual Funds and Investment Management Conference (Piowar Speech), available at <https://www.sec.gov/news/speech/031615-spch-cmsp.html>.
- <sup>25</sup> *See Final Rule: Election by Open-End Investment Companies To Make Only Cash Redemptions*, SEC Rel. No. IC-6561 (June 14, 1971).
- <sup>26</sup> Piowar Speech, *supra* n.24.
- <sup>27</sup> *Id.*
- <sup>28</sup> *Final Rule: Investment Company Liquidity Risk Management Programs*, SEC Rel. No. IC-32315 (Oct. 13, 2016) (Rule 22e-4 Adopting Release) and Rule 22e-4(b)(v) under the 1940 Act.
- <sup>29</sup> Rule 22e-4 Adopting Release, *supra* n.28, and Form N-1A, Item 11(c)(8).
- <sup>30</sup> *See* Signature Financial Group, SEC No-Action Letter (pub. avail. Dec. 28, 1999).
- <sup>31</sup> Such a system could incentivize intermediaries to agree to accept redemptions in-kind.
- <sup>32</sup> National Securities Markets Improvement Act of 1996, Public Law 104–290 (Oct. 11, 1996). Section 18 of the 1933 Act prohibits states imposing conditions on fund offerings or requiring registration or qualification (other than notice filings).
- <sup>33</sup> Under Rule 18f-1(b)(ii), a Rule 18f-1 election is irrevocable but can be rescinded by the SEC by order if that action is “appropriate in the public interest and consistent with the protection of investors.”
- <sup>34</sup> Prospectus for Fidelity Blue Chip Growth Fund and Fidelity Blue Chip Value Fund (Sept. 28, 2019) in the section “Shareholder Information—Additional Information about the Purchase and Sale of Fund Shares” (“Generally a fund expects to pay redemption proceeds in cash. ... In addition to paying redemption proceeds in cash, a fund reserves the right to pay part or all of your redemption proceeds in readily marketable securities instead of cash (redemption in-kind).”), available at <https://www.sec.gov/Archives/edgar/data/754510/000137949119004172/filing989.htm>.
- <sup>35</sup> The various steps for delivering portfolio securities are beyond the scope of this article, but would implicate the disclosures provided to shareholders.

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